December 2018

Monthly Commentary

Japan update

- Japanese equities rise on optimism of trade deal
- Outlook remains challenging, especially as the Chinese economy moderates
- But corporate results continue to exceed forecasts, albeit modestly

Market overview

Japanese equities rose in November, despite initial concerns over a slowing global economy and US-China trade friction. However, rising US markets fuelled a subsequent rally, helped by the Federal Reserve's dovish comments on a deceleration in interest rate hikes and a favourable turn to US-China trade negotiations. The yen depreciated slightly against the dollar but appreciated against the euro.

On the economic front, third-quarter GDP contracted in line with expectations by a seasonally-adjusted 0.3%. Both private consumption and business spending shrank. In September data, average household spending fell unexpectedly in tandem with a fall in monthly income. Spending on all items fell, except for clothing, which edged higher. Leading indicators eased, whereas core machinery orders fell by sharper than expected. For October, inflation met expectations and rose by 1.4%, led by higher prices for fuel and communications; unemployment worsened marginally to 2.4% on a seasonal basis; and industrial output rose by more than forecast as momentum picked up.

Looking ahead

While Japanese equities rebounded, global markets remain transfixed by the raft of ongoing challenges facing the global economy. These include fresh tension between the US and China in the wake of the arrest of Huawei's CFO; monetary-policy tightening across the globe; and political uncertainty in Europe. China's decelerating growth, meanwhile, poses headaches for all the other economies that are plugged into global supply chains, particularly Japanese businesses with substantial exposure to the mainland. Since early summer, orders of capital goods from China have slowed, with companies sidelined by uncertainty, while a tightening of peer-to-peer lending has dampened Chinese demand for larger ticket items. Unsurprisingly, the same companies that had done well previously, are now being punished.

Notwithstanding this, we believe that it is important to distinguish between shorter-term cyclical issues and the prospect of medium- to longer-term structural growth. Factory-automation stocks have fallen on the back of weaker orders in the near term, yet the needs of an ageing demographic and of improved manufacturing quality, in China or elsewhere, are here to stay. Similarly, the rise of the Chinese middle class puts Japanese products on a favourable footing. Hence, this period of macro-driven volatility, may provide longer-term investors the opportunity to take advantage of more attractive valuations. As such, we are reviewing our holdings as these macro events unfold. As well, our holdings, which possess structural growth drivers, wide competitive moats and solid balance-sheets should have the resilience to navigate these difficult times.

What we've been busy with

There were no major portfolio changes in November.

Nissan: giving up the Ghosn

Against the backdrop of a potential merger between Nissan and Renault, the timing of the dramatic arrest of Nissan chairman Carlos Ghosn appeared suspect. Some commentators have accused Nissan of using Japan's opaque criminal justice system to remove Renault's chief representative. While there may be many unanswered questions, the saga served as a timely reminder of the highly politicised auto industry and offers sound lessons about governance practices. We do not hold Nissan.

Aberdeen Standard Investments

NTT Docomo's self-harming cuts' limited impact

Telecommunications stocks tumbled after the market's largest mobile-phone carrier, NTT Docomo, stunned the industry and slashed its price plans by up to 40%. This followed several months of rising political pressure to cut high mobile tariffs. While shareholders have questioned the cuts, it must be noted that the Ministry of Finance holds 35% of Docomo's parent. Subsequent meetings with both Docomo and our holding, **KDDI**, however, revealed that the cuts will bring Docomo's more expensive price plans in line with other mobile providers.

Earnings modestly beat expections, share buybacks rise

Corporate results for the September quarter continued to unfold and in aggregate, have modestly exceeded forecasts. Encouragingly, year-to-date share buybacks are up 17% against last year, drawing level with the 2016 all-time high with a month left in 2018. Robust buyback activity suggests that companies are fairly confident of their prospects.

Asahi Intecc: poised for growth

Asahi Intecc formed an alliance with US medical-device maker Medtronic to distribute its neurovascular intervention products in the US. We believe this deal will have a significant impact on the company's future growth because such products command higher prices and better margins in a market that is expanding by about 10% annually. Separately, the company posted better-than-expected results that benefited from good sales in the US, as well as in China, where it converted rivals' capacity problems last year into permanent market share gains.

Amada lifts payout ratio after posting better results

Amada raised its full-year dividend and proposed buying back up to 2.6% of its shares, which would lift this year's payout ratio to 84%. This was on the back of better profits, thanks to healthy domestic demand. Amada also sold its leasing unit following our engagement with management about lightening its balance sheet. With cash making up nearly 30% of its book value, its balance sheet is not only healthy, but we believe there's scope for it to enhance shareholder returns further.

Sysmex: a victim of its own success

Sysmex reported sluggish results as sales of medical instruments and re-agents missed projections. This was due to a combination of slowing fundamentals and one-off issues. A victim of its own success, replacement sales have slowed since Sysmex captured more than half the global market share in haematology testing, and an even larger portion of the high-end market. Over the past decade, it had enjoyed double-digit sales growth for both instruments and re-agents. To counter the slowdown, Sysmex developed made-in-China products for lower-tier hospitals. However, approval delays for a new device have weighed on sales, with clients sidelined until a greenlight is given. We believe that Sysmex's valuations have fallen to attractive levels because the quality of its business remains intact. Growing healthcare needs will underpin rising demand for medical diagnostics, which in turn, should support the growth in its lucrative re-agents business.

We hold the companies highlighted.

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